The Trustee toolkit downloadable

An introduction to investment

Tutorial four: Types of asset – Alternative assets

By the end of this tutorial you will better understand:

- what alternative asset types are available
- the key characteristics of the major asset types

This tutorial is part of **Scenario two**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Alternative asset classes

Equities, bonds and cash are the asset classes that are used by most pension schemes. However, your scheme may invest in a number of other asset types, sometimes referred to as alternative asset types, such as:

- property
- infrastructure
- commodities
- private equity funds
- hedge funds
- multi-asset investments
- derivatives
- with-profits
- annuity policies

Some may grow in value, some may produce an income and some may do both.

We will also focus on what risk would be associated with such an investment as different asset types have different risk exposures as well as the potential for reward. It is helpful to get to know the different categories and grading for different asset classes so that you understand the relevance of the various types of investments in your pension scheme.

You will find more information on this topic in the Tutorial: 'Risk and reward' later in this module.

Property

Property is sometimes referred to as the fourth major asset type (the other three being equities, bonds and cash). It is also sometimes classified as an alternative asset type.

You will find more information in the Tutorials: 'Capital markets and economic cycles' and 'Risk and reward'.

Do we need to buy a building?

To invest in property, you don't need to own a building. Instead you can buy units in a property fund which invests in commercial properties or property funds. These units will rise and fall in value depending on the levels of supply and demand.

How liquid is the investment?

As properties can take a long time to buy or sell, investments in property are not usually as flexible (liquid) as equities or bonds. This can cause problems if assets need to be sold quickly to release cash. In the past, there have been periods when properties were not easy to sell. As a result, property funds have been 'closed' for a number of months which has meant that schemes have been prevented from selling property assets during this time.

The inability to sell an asset type can be a particularly significant problem for DC schemes because individual members are unable to transfer the value of their pot out of the scheme or to take their benefits until the fund is re-opened.

How do DB schemes access this type of asset?

DB schemes can invest in individual properties or in funds that hold a number of different properties.

How do DC schemes access this type of asset?

DC scheme members generally invest through property funds.

Can the scheme actually buy a property rather than invest in a fund?

Pension funds can also own commercial property (real estate) as part of their asset portfolio. Investment in residential property is permitted but not tax efficient for 'investment-regulated pension schemes' where there is a penal tax that applies in residential property and other types of asset.

Investment-regulated pension schemes are broadly self invested personal pension plans (SIPPs), personal pension schemes and occupational pension schemes with fewer than 50 members.

Infrastructure

Investing in infrastructure, such as roads or water systems, used to only be available to governments and public authorities but has now become an asset type in its own right for some pension funds.

How do DB schemes access this type of investment?

DB schemes typically invest in large-scale public systems, services and facilities, such as power, road or water systems, which are necessary for the functioning of a modern economy. Infrastructure investments aim to generate stable, long-term inflation-linked cash flows. It is possible to invest in infrastructure in two ways:

1. In a fund that invests directly in infrastructure investment projects.
2. Via a fund that invests in the companies that manage the infrastructure investments
(ie shares).

How do DC schemes access this type of investment?

Members of DC schemes do not typically make a standalone investment in infrastructure.

Commodities

Commodities are physical goods which include: foodstuffs such as wheat, metals such as copper and energy sources such as oil.

What affects commodity prices?

Commodity prices can be volatile, often as a result of geopolitical and weather events. Geopolitical means the effects of geography (both human and physical) on international politics and international relations. Commodity prices can rise in response to inflation and can cause inflation to rise.

An example of changing commodity prices

Following the Japanese earthquake and tsunami in March 2011, the prices of major food commodities fell. At the time, Japan was one the world's biggest importers of corn, soya beans and wheat. The week following the tsunami, prices in all three commodities fell reflecting prospects of lower import demand.

How do DB schemes access this type of investment?

Trustees of DB schemes can invest in commodities via a pooled fund to potentially mitigate a pension scheme's inflation risk.

You will find more information in the Tutorials: 'Capital markets and economic cycles'.

How do DC schemes access this type of investment?

DC scheme members do not typically make a standalone investment in commodities.

Private equity funds

Private equity funds sometimes buy shares in companies or funds that are not publicly quoted and are in different stages of development with a view to making substantial capital gains. Private equity funds do not normally provide regular income but they often include high levels of 'leverage'.

What is leverage?

The term leverage is used in the derivatives market and describes the ratio of the value of the derivative contracts held to the amount of cash available. Leverage increases the risk in a portfolio. You can learn more about derivatives and leverage later on in this tutorial.

How liquid is this asset?

Unlike listed equities, investors are usually 'locked in' for lengthy periods. These investments are therefore generally harder to buy and sell than listed equities.

Risk and reward for private equity funds

Private equity funds are an asset which offers high potential rewards over the longer term but a higher risk of loss of capital.

How do DB schemes access this type of asset?

For the reasons mentioned in liquidity and risk/reward, DB schemes which invest in private equity funds may wish to confine their investment to a small proportion of their equity portfolio.

How do DC schemes access this type of asset?

As private equity funds are less liquid that bonds or equities, DC scheme members do not typically invest in them.

Hedge funds

There are many different types of hedge fund and there is no set definition of what a hedge fund is.

What does a hedge fund aim to do?

Hedge funds aim to exploit anomalies and trends across the market using equities, bonds, commodities and more exotic investment opportunities.

What is an 'exotic investment opportunity'?

An 'exotic investment opportunity' is a market which isn't simply an equity, a bond or commercial property market. Here are some examples.

- Insurance-linked strategies: Buying investments that are linked primarily to the insurance cycle, rather than the economic cycle.
- Timberland: Buying commercial forests.
- Agriculture investments: Buying assets that are involved in the production of food, like farmland.
- Volatility strategies: Buying things that tend to do well when the equity markets move up and down much more or much less than usual.

What are the typical characteristics?

You will find more information in the Tutorial: 'Risk and reward'.

Hedge funds typically have at least some of the following characteristics. They:

- are less regulated than traditional investments
- aim to produce absolute returns rather than relative returns, which means that their investment returns are targeted without reference to a benchmark (for example, their investment objective could be to return 7% pa in absolute rather than to outperform a particular index by 2% pa)
- are leveraged
- are traded more actively than traditional assets
- use 'short' as well as 'long' investments

What is a 'short' and 'long' position?

In addition to holding a long position in assets and benefiting from an asset increasing in value, an investment manager can also benefit from a fall in the price of an asset by holding what is known as a 'short position'.

This is where an investment manager sells shares immediately (rather than holding on to them for a longer period), and has to buy them back before the end of an agreed borrowing period.

Why would an investment manager want a 'short' position?

The investment manager's expectation is that the shares will drop in price during this time and, as a result, the same number of shares can be bought back more cheaply.

If the investment manager gets it right, she buys back the shares at a lower price and makes a profit. However, if she is wrong and has to buy back the shares at a higher price, she makes a loss.

Example

If an investment manager believes that the weather over the coming summer is going to be very hot, she could borrow 1,000 shares in an umbrella company and sell them immediately for £1 per share (£1,000).

When the temperature rises she can buy them back for a lower price of 50p per share (£500) as demand for these would have fallen and the share price fallen accordingly. The manager then returns the shares to the broker, having made a profit of £500. Sale price (£1,000) - Purchase Price (£500) = Profit or Loss (£500 profit).

How liquid is this asset?

Many hedge funds may not be very liquid, and may only deal weekly, monthly, or even quarterly. This is due to the different types of strategies they employ. The investment manager can also suspend dealing to manage high levels of redemptions.

How do DB schemes access this type of asset?

DB schemes can invest directly with a hedge fund manager or invest in a 'fund of hedge funds'. This is a fund which invests in several different hedge funds.

How do DC schemes access this type of asset?

These are less suitable investments for DC scheme members because they are less liquid than other asset types.

Multi-asset investments

Multi-asset investments are a type of investment fund which enables investors to get exposure to a diverse range of specific markets or asset classes within one fund.

How do they work?

There are many different types of multi-asset investments with various objectives for expected levels of return and various structures. Typically these investments will set out which assets or markets they can invest in and what proportion can be invested in each.

This can be set as a range, for example: an investment manager may allocate 20-25% of the portfolio to global equities, 25-30% to UK equities, 20-25% to index-linked gilts, 5-10% to property and 3-5% to cash.

Example: Diversified growth fund

Diversified growth funds (DGFs) invest in a wide range of asset classes, with the allocations to those asset classes often being managed on an active basis as market conditions change.

You will find more information in the Tutorial: 'Risk and reward'.

For example, an investment manager may invest the portfolio 50% in equities and 50% in bonds. If the investment manager believes that equities will do better than bonds, the investment manager may increase its allocation to equities. If equities have performed well, the investment manager may decide to reduce the allocation to equities in anticipation that they may perform less well in the future. The investment manager may move into cash or another asset class that he or she believes will do well and will protect the portfolio from sharp falls in other asset classes. These funds typically target returns similar to equity returns but with lower risk/volatility than equities.

Example: Emerging market multi-asset fund

Emerging market multi-asset funds are a type of fund which can invest across emerging equity, bond and currency markets. They aim to deliver emerging market like equity returns but with significantly lower risk than emerging market equity volatility.

Example: Multi-asset credit fund

A multi-asset credit fund invests across a broad range of bond and debt asset classes, predominantly in more risky bond assets than a pension scheme would typically hold.

Example: Multi-asset sustainable fund

Multi-asset sustainable funds are a type of fund which can invest across a broad range of asset classes but only in individual assets within those asset classes which meet certain sustainability criteria.

The sustainability criteria applied to individual funds may vary depending on the focus of the investment manager of the fund but typically they see investments in assets which exceed certain threshold criteria for environmental, social and governance (ESG) factors which support long-term value creation.

Some multi-asset sustainable funds may focus mainly on sustainability and resilience in light of environmental factors, such as climate change risks.

How do DB schemes access this type of asset?

DB schemes typically access multi-asset exposures like these via an investment in a pooled fund. However segregated portfolios are available.

How do DC schemes access this type of asset?

DC scheme members can invest in multi-asset funds to diversify their investments if they are offered by the scheme.

Derivatives

Derivatives are investment instruments or contracts which are based upon (ie derived from) the value of an underlying asset or set of assets. These instruments include forward contracts, futures, options and swaps.

Forward contract

These are contracts/agreements for the delivery of a specified asset at an agreed date in the future, for a price agreed upfront. Forward contracts are not normally traded on a recognised exchange for example the London Stock Exchange.

For example the seller agrees to sell an item for an agreed price on an agreed date. The seller offers this in expectation that the price will go down in the meantime and they will make a profit. The buyer agrees to buy at the agreed price at the agreed time in the expectation that the price will go up in the meantime and they will make a profit.

Futures

These are contracts for the delivery of a specified asset at a date in the future, for a price agreed upfront. Futures differ from forward contracts in that they are standardised. They are traded in specified sizes, on recognised exchanges, and are mark-to-market, requiring margin payments. A margin payment is the initial amount of cash that must be deposited to start trading contracts. It acts as a down payment for the delivery of the contract and ensures that the parties honour their obligations.

Mark-to-market is the process of giving a value to the future contract (or other derivative contract) based on its current market price or the current market price for a similar instrument. This is done throughout the life of the contract.

As the value of the contract changes, the party who has in theory made a loss since the contract was last valued, pledges collateral to the other party. Collateral is a pledge of assets, typically cash or gilts, and is commonly used to reduce the financial impact of the failure of one party to pay the other party at the end of the contract.

Futures are commonly used in commodity markets where the transportation of the goods (such as oil) has to be organised well in advance, but are also available for many other assets such as currencies, equities and bonds.

Options

These are contracts which give the buyer the right, but not the obligation, to buy (or sell) an asset at some date in the future at a price agreed now. The price paid for the option is called the premium.

Swaps

These are contracts between two parties who agree to exchange one set of cash flows for another. Swaps are traded on an over-the-counter basis, which allows them to be tailored to individual circumstances. The term 'over-the-counter' or OTC can be used to describe how unlisted equities and derivatives are traded. They are traded via a dealer network as opposed to on a recognised exchange.

Swaps are most often used to hedge against changes in interest rates and/or inflation, although they can also be used to generate profit.

How do DB schemes access this type of asset?

Many DB schemes invest in these instruments to protect against changes in interest rates and inflation expectations. These are typically known as liability driven investments (LDI). LDI is commonly used by DB schemes, in either segregated or pooled funds.

How do DC schemes access this type of asset?

Derivatives are not widely used in DC schemes.

With-profits

With-profits funds are a type of investment with a life assurance provider.

How does it work?

The money put in is pooled with other investors' money and invested in a mixture of shares, bonds, property and cash. If the investment performs well, the investor will receive an annual bonus, as well as a 'terminal' bonus when the policy matures (comes to an end).

What makes with-profits investments unique is the 'smoothing' process, whereby some of the return from the investments in the fund is kept back in the years when the fund performs well and used to pay you more than the underlying return on the funds in years when it performs less well.

What is a 'market value reduction'?

A market value reduction (or market value adjustment) is sometimes applied to a with-profits policy if an attempt is made to cash-in the policy early (before the maturity date). It reduces the value of the policy.

These have been applied from time to time for a number of reasons. There have been examples where providers paid out too much in bonuses during the early years, when they were competing to attract new business, and didn't have enough left to pay further bonuses later in the policy term when markets took a downturn and the value of the investments shrank.

They can also be applied in times of weak fund performance, to ensure members do not leave with more than their fair share.

How do DB schemes access this type of asset?

With-profits funds are rarely used by DB schemes as part of the main scheme assets, but are commonly offered as an investment option within additional voluntary contribution (AVC) schemes.

You will find more information in the Case example: 'Equitable Life' which you can download from the course page or the 'Resources' tab on the website.

How do DC schemes access this type of asset?

Very few DC schemes now offer with-profits investments to their members although schemes may have legacy investments.

Annuities (DB only)

Buy-in

DB scheme trustees may choose to 'buy-in' some of the schemes expected future benefit payments by purchasing a bulk contract with an insurance company. A bulk contract is one covering many individuals.

Why would trustees want to do this?

This allows trustees to reduce their scheme's risk by acquiring an asset (the annuity contract) whose cash flows are designed to meet ie 'match' a specified set of benefit payments under the pension scheme.

How does this work?

The contract is held by the trustees and responsibility for the benefit payments remains with the trustees.

Common uses of buy-in arrangements have been to cover the payments associated with current pensioners or a sub-set of those members. Contracts to meet payments to members who are yet to become pensioners have also been purchased.

How does this affect the investment strategy?

From an investment strategy perspective, a buy-in is effectively a type of bond investment; it performs a similar role to traditional bonds but with the typical added advantages that:

- interest rate and inflation mismatch risk associated with the benefits covered by the buy-in only can be eliminated
- longevity risk associated with the benefits covered by the buy-in can be eliminated. A DB scheme's bond investments will not typically provide any protection against the impact of this risk

Buy-out

DB scheme trustees may choose to 'buy-out' some, or all, of their scheme's expected future benefit payments by purchasing a bulk contract with an insurance company. A bulk contract is one covering many individuals.

The insurer then becomes responsible for meeting pension benefits due to scheme members (affected ultimately by allocating to each scheme member an individual annuity contract). Following a full buy-out (ie one covering all scheme members), and having discharged all of the trustees' liabilities, the pension scheme would normally be wound up.

You will find more information in the Module: 'Funding your DB scheme'.